VANUATU FINANCIAL SERVICES COMMISSION

GUIDANCE NOTES

ON

OUTSOURCING ARRANGEMENTS

SUPERVISION DEPARTMENT

1. Introduction

Non-Bank Financial institutions including Financial Dealers in Securities outsource business activities, functions and processes to meet the challenges of technological innovation, increased specialization, cost control, and heightened competition. However, outsourcing can increase an institution's dependence on third parties, which may increase its risk profile.

Many financial sector regulators have responded by introducing guidance related to the management of outsourcing risks, hence VFSC is issuing this guidance on the same basis.

This Guideline sets out VFSC's expectations for financial dealers who are regulated entities under the Financial Dealers Licensing Act that outsource, or contemplate outsourcing, one or more of their business activities to a service provider. These expectations should be considered prudent practices, procedures or standards that should be applied according to the characteristics of the outsourcing arrangement and the circumstances of the licensee.

Financial Dealers have the flexibility to configure their operations in the way most suited to achieving their corporate objectives. However, this Guideline operates on the premise that **licensed entities retain ultimate accountability for all outsourced activities**. Furthermore, VFSC's supervisory powers should not be constrained, irrespective of whether an activity is conducted in-house, outsourced, or otherwise obtained from a third party.

Under this Guideline, licensed entities who have outsourced or wish to outsource part of their management functions to a third party are expected to:

- evaluate the risks associated with all existing and proposed outsourcing arrangements;
- develop a process for determining the materiality of arrangements;
- implement a program for managing and monitoring risks, commensurate with the materiality of the arrangements;
- ensure that senior management receives information sufficient to enable them to discharge their duties under this Guideline.

2. Definitions

Outsourcing Arrangement

For the purposes of this Guideline, an outsourcing arrangement is an agreement between a Licensee and a service provider, whereby the service provider performs a business activity, function or process that is, or could be, undertaken by the Licensee itself. A Licensee may consult with VFSC when they are uncertain whether a particular arrangement falls within this definition.

3. At a minimum, VFSC expects the following to be addressed when a Licensee enters into a material outsourcing arrangement with another entity:

a) a holder of Class D license cannot outsource the position of the **“Chief Technology officer”.**

b) an outsourcing agreement that details, among other things, the scope of the arrangement, the services to be supplied, the nature of the relationship between the Licensee and the service provider, and procedures governing the subcontracting of services;

c) an appropriate business continuity plan;

d) a process for monitoring and oversight;

e) a due diligence process that addresses the qualitative aspects of the arrangement, particularly those pertaining to the unique operational requirements of the Licensee;

f) procedures governing the subcontracting of services;

g) legislative requirements relating to location of records.

4. Accountability and Control

Management Responsibilities

A Licensee should have appropriate risk management policies and practices that are regularly reviewed. In terms of the specific risks arising from outsourcing, it is expected that, in carrying out this duty, senior management would periodically:

a) approve or reaffirm the policies that apply to outsourcing arrangements (e.g., risk philosophy, materiality criteria, risk management program and approval limits); and

b) review a list of all the Licensee’s material outsourcing arrangements and other relevant reports, when appropriate.

5. Assessment for Outsourcing Arrangements

VFSC expects that a Licensee will design a risk management program that applies to all its outsourcing arrangements. Without limiting the scope of the assessment, factors that the Licensee should consider include:

a) the impact of the outsourcing arrangement on the finances, reputation and operations of the Licensee, or a significant business line, particularly if the service provider, or group of affiliated service providers, should fail to perform over a given period of time;

b) the ability of the Licensee to maintain appropriate internal controls and meet regulatory requirements, particularly if the service provider were to experience problems;

c) the cost of the outsourcing arrangement;

d) the degree of difficulty and time required to find an alternative service provider or to bring the business activity 'in-house'; and

e) the potential that multiple outsourcing arrangements provided by the same service provider can have an important influence – in aggregate – on the Licensee.

6. Risk Management Program for Material Outsourcing Arrangements

In general, VFSC expects that a Licensee will design a risk management program that applies to all its outsourcing arrangements, except those that are clearly immaterial, and that the risk mitigation employed will be commensurate with the Licensee's assessment of the risks associated with the particular outsourcing arrangement.

7. Due Diligence Processes

VFSC expects a Licensee to conduct an internal due diligence to determine the nature and scope of the business activity to be outsourced, its relationship to the rest of the entity's activities, and how the activity is managed.

In selecting a service provider, or substantially amending or renewing a contract or outsourcing agreement, Licensees are expected to undertake a due diligence process that fully assesses the risks associated with the outsourcing arrangement, and addresses all relevant aspects of the service provider, including qualitative (i.e., operational) and quantitative (i.e., financial) factors. When out-of-Vanuatu outsourcing is being contemplated, the Licensee should pay particular attention to the legal requirements of that jurisdiction, as well as the potential foreign political, economic and social conditions, and events that may conspire to reduce the foreign service provider's ability to provide the service, as well as any additional risk factors that may require adjustment to the risk management program.

8. Policies and Procedures to Manage Risks Associated with Material Outsourcing Arrangements

Contract for Services

VFSC expects material outsourcing arrangements to be documented by a written contract that addresses all elements of the arrangement and has been reviewed by the Licensee's legal counsel. Some of the items identified below may not be applicable in all circumstances; however, Licensees are expected to address all issues relevant to managing the risks associated with each outsourcing arrangement to the extent feasible and reasonable given the circumstances, and having regard to the interests of the Licensee.

a) Nature and Scope of the Service Being Provided

The contract or outsourcing agreement is expected to specify the scope of the relationship, which may include provisions that address the frequency, content and format of the service being provided. The contract or outsourcing agreement is expected to detail the physical location where the service provider will provide the service.

b) Performance Measures

Performance measures should be established that allow each party to determine whether the commitments contained in the contract are being fulfilled.

c) Reporting Requirements

The contract or outsourcing agreement is expected to specify the type and frequency of information the Licensee receives from the service provider. This would include reports that allow the Licensee to assess whether the performance measures are being met and any other information required for the Licensee's monitoring program. In addition, the contract or outsourcing agreement is expected to include procedures and requirements for the service provider to report events to the Licensee that may have the potential to materially affect the delivery of the service.

d) Dispute Resolution

VFSC expects the contract or outsourcing agreement to incorporate a protocol for resolving disputes. The contract or outsourcing agreement should specify whether the service provider must continue providing the service during a dispute and the resolution period, as well as the jurisdiction and rules under which the dispute will be settled.

e) Defaults and Termination

The contract or outsourcing agreement is expected to specify what constitutes a default, identify remedies, and allow for opportunities to cure defaults or terminate the agreement. The Licensee is expected to ensure that it can reasonably continue to process information and sustain operations in the event that the outsourcing arrangement is terminated or the service provider is unable to supply the service. Appropriate notice should be required for termination of service and the Licensee's assets should be returned in a timely fashion. In particular, data and records relating to data processing outsourcing arrangements should be returned to the Licensee in a format that would allow the Licensee to sustain business operations without prohibitive expense.

The contract or outsourcing agreement should not contain wording that precludes the service from being continued in situations where the Licensee is in liquidation.

f) Ownership and Access

Identification and ownership of all assets (intellectual and physical) related to the outsourcing arrangement should be clearly established, including assets generated or purchased pursuant to the outsourcing arrangement. The contract or outsourcing agreement should state whether and how the service provider has the right to use the Licensee's assets (e.g., data, hardware and software, system documentation or intellectual property) and the Licensee's right of access to those assets.

g) Contingency Planning

The contract or outsourcing agreement should outline the service provider's measures for ensuring the continuation of the outsourced business activity in the event of problems and events that may affect the service provider's operation, including systems breakdown and natural disaster, and other reasonably foreseeable events. The Licensee should ensure that the service provider regularly tests its business recovery system as it pertains to the outsourced activity, notifies the Licensee of the test results, and addresses any material deficiencies. The Licensee is expected to provide a summary of the test results to VFSC upon request. In addition, the Licensee should be notified in the event that the service provider makes significant changes to its business resumption and contingency plans, or encounters other circumstances that might have a serious impact on the service.

h) Audit Rights

The contract or outsourcing agreement is expected to clearly stipulate the audit requirements and rights of both the service provider and the Licensee. At a minimum, it should give the Licensee the right to evaluate the service provided or, alternatively to cause an independent auditor to evaluate, on its behalf, the service provided. This includes a review of the service provider's internal control environment as it relates to the service being provided.

i) Confidentiality, Security and Separation of Property

At a minimum, the contract or outsourcing agreement is expected to set out the Licensee’s requirements for confidentiality and security. Ideally, the security and confidentiality policies adopted by the service provider would be commensurate with those of the Licensee and should meet a reasonable standard in the circumstances. The contract or outsourcing agreement should address which party has responsibility for protection mechanisms, the scope of the information to be protected, the powers of each party to change security procedures and requirements, which party may be liable for any losses that might result from a security breach, and notification requirements if there is a breach of security.

VFSC expects appropriate security and data confidentiality protections to be in place. The service provider is expected to be able to logically isolate the Licensee's data, records, and items in process from those of other clients at all times, including under adverse conditions.

j) **Pricing**

The contract or outsourcing agreement should fully describe the basis for calculating fees and compensation relating to the service being provided.

k) **Insurance**

The service provider should be required to notify the Licensee about significant changes in insurance coverage and disclose general terms and conditions of the insurance coverage.

9. Location of Records

In accordance with the Financial Dealers Licensing Act and other relevant legislations, certain records of entities carrying on business in Vanuatu should be maintained in Vanuatu. In addition, the Licensee is expected to ensure that VFSC can access in Vanuatu any records necessary to enable VFSC to fulfil its supervisory mandate.

10. Business Continuity Plan

A Licensee's business continuity plan should address reasonably foreseeable situations (either temporary or permanent) where the service provider fails to continue providing service. The business continuity plan and back-up systems should be commensurate with the risk of a service disruption. In particular, the Licensee's business continuity plan should ensure that the Licensee has in its possession, or can readily access, all records necessary to allow it to sustain business operations, meet its statutory obligations, and provide all information as may be required by VFSC to meet its supervisory mandate, in the event the service provider is unable to provide the service.

11. Outsourcing in Foreign Jurisdictions

When the material outsourcing arrangement results in services being provided in a foreign jurisdiction, the Licensee's risk management program should be enhanced to address any additional concerns linked to the economic and political environment, technological sophistication, and the legal and regulatory risk profile of the foreign jurisdiction(s).

12. Monitoring and Oversight of Material Outsourcing Arrangements

Every Licensee engaged in material outsourcing should develop, implement and oversee procedures to monitor and control outsourcing risks in accordance with its outsourcing risk-management policies. The sophistication of the procedures should be commensurate with the size and complexity of the outsourcing arrangement(s) and with the expectations of this Guideline. Management is expected to prepare reports based on the Licensee's monitoring and oversight activities. These reports may outline the success of the outsourcing arrangement and the effectiveness of the risk management program and may be reflected in the documentation delivered to the Licensee's senior management. .

13. Monitoring the Outsourcing Arrangement

The Licensee should monitor all material outsourcing arrangements to ensure that the service is being delivered in the manner expected and in accordance with the terms of the contract or outsourcing agreement. Monitoring may take the form of regular, formal meetings with the service provider and/or periodic reviews of the outsourcing arrangement's performance measures. Within a reasonable time, the Licensee should advise VFSC of any events that are likely to have a significant negative impact on the delivery of the service.

14. A Licensee should review its material outsourcing arrangements to ensure compliance with its outsourcing risk policies and procedures and with the expectations of this Guideline. Reviews of material outsourcing arrangements should be periodically undertaken by the Licensee's internal audit department or another independent review function either internal or external to the Licensee, provided it has the appropriate knowledge and skills. The Licensee's senior management, will always retain overall accountability for the outsourcing arrangement.

Reviews should test the Licensee's risk-management activities for outsourcing in order to:

a) ensure risk-management policies and procedures for outsourcing are being followed;

b) ensure effective management controls over outsourcing activities;

c) verify the adequacy and accuracy of management information reports; and

d) ensure that personnel involved in risk-management for outsourcing are aware of the Licensee's risk-management policies and have the expertise required to make effective decisions consistent with those policies.

Management should adjust the scope of the review depending on the nature of the outsourcing arrangement.

15. Monitoring the Service Provider

At least annually, the Licensee should review the service provider to ascertain its ability to continue to deliver the service in the manner expected. This review would be commensurate with the level of risk involved and could include an assessment of the service provider's circumstances including its financial strength, prospects, technical competence, and use and performance of significant subcontractors.

Annex 1 - Examples of Outsourcing Arrangements

The outsourcing domain is diverse and growing. Some examples may include:

- Information system management and maintenance (e.g., data entry and processing, data centres, facilities management, end-user support, local area networks, help desks);
- Custody of digital assets or security tokens
- Document processing (e.g., cheques, credit card slips, bill payments, bank statements, other corporate payments);
- Application processing (e.g., insurance policies, loan originations, credit cards);
- Policy administration (e.g., premium collection, policy assembly, invoicing, endorsements);
- Claims administration (e.g., loss reporting, adjusting);
- Loan administration (e.g., loan negotiations, loan processing, collateral management, collection of bad loans);
- Investment management (e.g., portfolio management, cash management);
- Marketing and research (e.g., product development, data warehousing and mining, advertising, media relations, call centres, telemarketing);
- Back office management (e.g., electronic funds transfer, payroll processing, custody operations, quality control, purchasing);
- Real estate administration (e.g., building maintenance, lease negotiation, property evaluation, rent collection);
- Professional services related to the business activities of the Licensee (e.g., accounting, internal audit, actuarial); and
- Human resources (e.g., benefits administration, recruiting).

This Guideline generally would not apply to the following:

- Courier services, regular mail, utilities, telephone;
- Procurement of specialized training;
- Discrete advisory services (e.g., legal opinions, certain investment advisory services that do not result directly in investment decisions, independent appraisals, trustees in bankruptcy);
- Purchase of goods, wares, commercially available software and other commodities
- Independent audit reviews;
- Credit background and background investigation and information services;
- Market information services (e.g., Bloomberg, Moody's);
- Independent consulting;
- Services the Licensee is not legally able to provide;
- Printing services;
- Repair and maintenance of fixed assets;
- Supply and service of leased telecommunication equipment;
- Travel agency and transportation services;
- Correspondent banking services;
- Maintenance and support of licensed software;
- Temporary help and contract personnel;
- Fleet leasing services;
- Specialized recruitment;

- External conferences;
- Clearing and settlement arrangements between members or participants of recognized clearing and settlement systems;
- Sales of insurance policies by agents or brokers;
- Ceded insurance and reinsurance ceded; and
- Syndication of loans.

Please contact the following person should you have any questions:

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